

**Remarks by Lynn Patterson
Deputy Governor of the Bank of Canada
Hamilton Chamber of Commerce
Hamilton, Ontario
March 7, 2019**

Economic Progress Report: Sensible Shifts in Household Spending

Introduction

Good afternoon.

I'm happy to be here to give you an update on the Canadian economy and discuss the decision we made yesterday to keep our key policy interest rate unchanged.

This decision hinged on a number of factors. One was the slowing momentum in the global economy. It is increasingly clear that ongoing trade tensions and associated uncertainties are having an impact. I'm sure many of you here in Hamilton can relate to that as you deal with the steel tariffs.

Another factor was the performance of the Canadian economy in the fourth quarter of 2018. While we had been anticipating a slowdown, coming primarily from the oil sector, it was sharper and more broad-based than expected. This is despite strong employment and labour income growth and core measures of inflation that have continued to hover near 2 per cent.

Part of that sharper slowdown came from weakness in household spending in Canada. That's what I'd like to spend the bulk of my time talking about today. But first, let's step back and take a look at how the economy evolved to this point over the past couple of years.

As many of you may recall, 2017 was a very strong year—growth came in at 3 per cent, with notable contributions from investment, exports and household spending.

The growth in household spending was supported by employment gains, which fed into a healthy rise in disposable income growth of 4½ per cent. Income tax cuts and the Canada Child Benefit provided a further boost to spending. And in an environment of steady house price appreciation and favourable conditions for borrowing, spending on housing continued to increase. With growth above potential, the slack in the economy diminished and inflation was approaching 2 per cent. So in mid-2017, we began to move our policy rate.

I would like to thank Sharon Kozicki and Eric Santor for help in preparing this speech.

For 2018 as a whole, the economy grew by 1.8 per cent. While this moderation in growth had been anticipated, it was shy of our forecast in the January [Monetary Policy Report](#) (MPR). Growth in 2018 was again broad-based, with solid contributions from exports, investment and household spending, the latter of which eased to a more realistic pace last year from the unsustainable rate in 2017. Our forecast is that this easing in household spending will continue throughout 2019–20.

As for inflation, it rose from about 2 per cent at the beginning of 2018 to peak at 3 per cent mid-year, reflecting the transitory impact of higher gasoline prices and airfares. By mid-autumn, oil prices began to fall, contributing to the return of inflation to 2 per cent by the end of the year. While there was a bit of volatility through the year, inflation remained near target and all three measures of core inflation were around 2 per cent. This was in line with our view that the economy was operating close to capacity.

Looking ahead—and consistent with the numbers we recently received for January—we are forecasting inflation to be slightly below 2 per cent for most of 2019. This is largely the result of temporary factors, including the decline in oil prices since last October, and a wider output gap.

Given this context, let me now turn to household spending. It is always an important topic because it makes up more than half of the economy. But it's even more so today as we think about how high levels of household debt are affecting spending decisions. I'm going to discuss what household spending includes, what influences it and, most importantly for monetary policy, the factors that have contributed to the moderation in spending that we've seen over the last year.

Defining housing and consumption

Let me start by defining where different kinds of purchases end up in our forecasts.

Statistics Canada considers the construction of a new house, renovations and the costs associated with buying an existing house part of a category termed residential investment or, for our purposes, housing.

In contrast, consumption is defined as spending on [goods and services](#), which are typically consumed by the household within the year they are purchased. Goods account for about 45 per cent of consumption and cover everything from cars to clothing, groceries to gardening tools. The remaining 55 per cent is services. These range from haircuts to childcare, tuition, restaurant meals, vacations and—the biggest part—rent and utility bills. Rent is defined as either the amount you pay as a tenant or, if you own a house, a portion of the cost of living in it. This portion is roughly equivalent to what you would be paying if you were renting.

Slowing housing and consumption

Canadians dialed back their spending in 2018. Consumption growth moderated by about 1½ percentage points from 2017, and housing by almost 5 per cent. This resulted in an overall contribution of household spending to annual gross

domestic product (GDP) that was about 1¼ percentage points lower than it had been in 2017 and is a bit softer than we projected in our January [MPR](#).

We have been expecting an adjustment for some time. Last March, my colleague Deputy Governor Timothy Lane noted in our first economic progress report [speech](#) that housing investment and consumption would, over time, contribute less as exports and business investment contribute more. This is partly because in mid-2017 we had begun to remove some of the policy accommodation that had been in place for many years. Since then, we've increased our policy rate from 0.50 per cent to 1.75 per cent in October of last year.

Our policy rate is transmitted to the economy through various channels. It affects returns on savings and investments as well as borrowing rates. It also has a small direct effect on inflation from higher mortgage interest costs. Thus, it affects decision making by households and firms, influencing spending and borrowing patterns.

After the global financial crisis, low borrowing rates led households to take on debt, primarily through the housing market. The ratio of household debt to disposable income rose and vulnerabilities related to the household sector increased.

We have been closely monitoring these developments for some time. Research in this area clearly showed that households would be more sensitive to interest rate movements than in past cycles, with the highly indebted most affected.¹ In 2017, we adjusted our models to account for this increased sensitivity.

Housing

Turning to the housing market, a combination of factors—some new and some already in place—affected it throughout 2018.

First, additional mortgage guidelines were introduced in January. They were aimed at improving the future resilience of new household debt. The guidelines introduced a new stress-test requirement for low-ratio mortgages. For some households, this meant a reduction in the amount that they could borrow. Borrowers can adjust through various channels. They could choose to purchase a smaller home, buy in a different neighbourhood, rent rather than buy, or delay their purchase by saving for a larger down payment or waiting for prices to adjust.²

The guidelines are having their intended effect. The quality of new borrowing has improved, with far fewer households taking out a mortgage with a debt-to-income ratio above 450 per cent.³

¹ See “Box 3: The Impact of Rising Interest Rates on Mortgage Holders,” Bank of Canada [Monetary Policy Report](#) (July 2018): 15–16.

² The Bank estimates that the B-20 guidelines would lower the level of GDP by 0.2 per cent by the end of 2020.

³ See “Box 4: The Impact of Policy Changes on Mortgage Lending,” Bank of Canada [Monetary Policy Report](#) (October 2018): 13–14.

Second, rules were put in place over the past three years by various provincial and municipal governments to curb speculative activity and, in British Columbia, these rules were further augmented.

And third, mortgage interest rates continued to rise. In mid-2017, the average five-year fixed mortgage rate was 2.7 per cent. By the end of last year this rate had moved to around 3.7 per cent.

These factors caused all facets of housing to moderate. As a result, the housing market remains in a state of adjustment and flux, with wide regional differences. It is important to keep in mind that we've seen many housing markets moderate in countries such as Australia and the United Kingdom as the level of investor activity declined.

The bulk of the slowdown has come from lower resale activity in the greater Vancouver and greater Toronto areas. In Calgary, the volume of home sales is off by 17 per cent from a year ago, likely reflecting the decline in the oil sector. In contrast, over the same period we've seen a pickup of sales in cities like Winnipeg, Ottawa and Montréal. Overall, house prices rose by 4 per cent in 2018, consistent with the pace of national labour income growth.

In many major markets we are also seeing shifts in construction from single-family detached homes to condos and other multi-family units, reflecting demand shifts as well as geographic constraints. For example, in the Greater Toronto Area, by the end of 2018, starts of single-family detached houses had fallen by more than half to their lowest level since 1995, while the construction of multiples had increased by about 25 per cent in 2018. We are seeing the same pattern in Calgary, Montréal and here in Hamilton.

So, in general, complex adjustments, which do take time, are underway in housing markets, with significant variability across regions. At the Bank, we are tracking these changes, given the importance of the housing market to the economy.

Consumption

Now let's look at consumption.

About 35 per cent of our household spending is relatively stable. That's because the largest portion—roughly 20 per cent—is rent or an equivalent cost if you own your house. Both tend to tick up a little every year. Spending on other necessities, such as on your water bill or toothpaste, also contributes to the stability of consumption. You tend to pay your bill and brush your teeth regardless of your debt levels and the state of the economy.

But some spending is more optional, such as on new cars, travel abroad, recreation and restaurant meals. It is in these categories where we are seeing some shifts in spending habits. Let me start with cars.

When Canadians have the money or can borrow it, a new car is often a priority. From the Great Recession until last year, more people were buying new vehicles each year. In 2017, the pace of new car buying hit its highest share of consumption in 14 years. But sales of new cars began to soften last year, falling by 1.7 per cent from 2017 levels. That's not a huge surprise, given that people

generally don't buy a new car every year. At the same time, higher interest rates and the slowing economy likely also had an impact. In the energy-producing regions, which normally account for roughly 15 per cent of the total, sales fell by 6 per cent.

Some other categories of discretionary spending also slowed in 2018. For example, the growth in spending on vacations softened. And while many households still went out for dinners and entertainment, spending growth in these areas fell from around 3 per cent in 2017 to close to 1 per cent last year.

While we know that higher interest rates play an important role in these declines, there are other influences as well:

1. The first is income effects. As the prices of some of the products we export—such as oil—decline, it reduces our national income. Oil and other commodity prices retreated over 2018. And disposable income, which grew at a pace of 4½ per cent in 2017, slowed to about 3½ per cent last year.
2. Then there are wealth effects—when house prices and stock markets are rising, people tend to feel good and spend more. The reverse is also true, and that was the case last year.
3. And lastly, confidence effects. Whether you are directly affected by the trade actions going on, or your neighbour is, uncertainty continues to hang over the economy, weighing on confidence.

In the end, it's some combination of these elements that is weighing on consumption and causing Canadians to be more cautious about their spending.

The state of household finances

Most Canadians are managing the higher carrying costs of their debt by scaling back their spending in some of the areas that I have just highlighted, as well as in housing. In addition, Canadians have cut back on their consumer financing. We have seen a slowing in the combined growth of personal loans and credit cards from about 4 per cent in December 2017 to about 2 per cent in December 2018.

We are also seeing very low levels of arrears rates and insolvencies across the country. While there may be increases of both in certain sectors or regions, they are rising from a low base and remain near historically low levels. That's not to say that for some individuals, struggling to keep up with their payments isn't demanding painful adjustments. Overall, however, the data suggest that the majority of households are managing their debt levels.

Factors behind our decision

Let me turn now to our interest rate decision yesterday and the main points of Governing Council's discussions. I'll start with a few comments about the global economy.

As we noted in our MPR in January, there has been a slowdown in global economic activity. This reflects in part some temporary factors, including the US government shutdown and production adjustments made by European car manufacturers. However, some of the slowdown is related to ongoing trade

tensions and negotiations, and therefore may be more persistent. We've seen evidence of this in some of the recent data from China, as well as from other emerging economies. Meanwhile, the US economy is moderating, as expected, and we anticipate that it will continue to slow to a pace closer to its potential.

Some major central banks have changed their communications in recognition of softer global economic momentum. Their shift in tone has contributed to an easing in global financial conditions—many equity markets have rebounded from earlier lows and credit spreads have narrowed.

Of course, the main source of uncertainty in the global economy continues to be the future of trade policy, notably the current talks between the United States and China. While there have been some promising signs in those negotiations, trade uncertainty on a global basis remains a two-sided risk—an escalation or expansion of trade actions could have serious consequences for the global and Canadian economies. On the other hand, successful resolution of trade tensions would remove a significant source of uncertainty and provide a major lift.

Here at home, Canadian data are reflecting this slower global momentum. In that regard, Governing Council spent a lot of time discussing the national accounts data for the fourth quarter of last year, which were published on Friday. In our January MPR, we said that we were expecting weakness in the fourth quarter of 2018 and the first quarter of this year. This was due to the decline in oil prices late last year, coupled with production curtailments, which had an impact on the energy sector. We projected that growth would then pick up, starting in the second quarter.

As it turned out, the slowdown in the fourth quarter was sharper and more broad-based than we expected. This came despite strong growth in employment and labour income. While the anticipated slowdown from the energy sector was fairly aligned with our projections, other categories surprised. As such, and given that the data present a mixed picture, I'm going to spend a bit more time on the national accounts numbers we received last week.

Let me walk through the main economic categories, starting with business investment. For 2018 as a whole, investment grew by 2 per cent, which was less than we had expected. This reflected weakness in both the third and fourth quarters. So what might explain this? While many companies were relieved to see the successful negotiations to replace NAFTA with the Canada-United States-Mexico Agreement, they continue to wait for the deal to be ratified. It's possible that some companies are delaying investments amid the uncertainty. And, of course, the uncertainty isn't limited just to the new NAFTA—global concerns, particularly on the US-China trade front, are clearly hurting confidence and leading firms to delay investment decisions.

Another possible explanation for the weakness in investment is timing. The accelerated depreciation tax changes announced late last year by the federal government are welcome news for corporations, and it's possible that in anticipation of the changes, investment decisions were postponed. If so, we should begin to see a pickup in the first quarter of this year, which would be consistent with recent quarterly readings from our *Business Outlook Survey*. We will have an updated survey to further inform our April decision.

Next up is exports, where the profile was also weaker than expected. One bright spot in exports was services, which grew by more than 6 per cent in the quarter, led by commercial and travel services.

I've already talked a fair bit about housing, and the biggest negative surprise in that category during the fourth quarter came from renovations. As I noted before, there are significant adjustments occurring in housing markets, and it will take time for these adjustments to be completed. Nevertheless, the national rate of mortgage credit growth increased slightly, also in the fourth quarter, and we'll see what happens with sales once spring rolls around.

And I'll end on the topic of my speech today—consumer spending. It, too, was lower than we expected in the fourth quarter, with categories more sensitive to interest rates continuing to soften. We are aware that many purchases in the consumption category would be linked to a purchase of a new home, so that's likely a contributing factor. But to better determine the factors at play, we will need more data.

Conclusion

Although we figured the economy was in for a detour at the end of last year, that detour may wind up being longer than we had expected. It now appears the economy will be weaker in the first half of 2019 than we had projected in January. However, we still expect Canadian economic growth to pick up later in the year, supported by ongoing strength in employment and rising wages. We will have more to say in April, when we will have a new economic projection, as well as our annual updated estimates for economic potential and the neutral interest rate.

At yesterday's decision, Governing Council judged that the outlook continues to warrant a policy interest rate that is below its neutral range. Given the mixed picture that the data present, it will take time to gauge the persistence of below-potential growth and the implications for the inflation outlook. With increased uncertainty about the timing of future rate increases, Governing Council will be watching closely developments in household spending, oil markets and global trade policy.